

GENERAL COUNSEL'S OPINION NUMBER 55-29, DATED 3 NOVEMBER 1955

Cost-of-living allowances paid to employees are not subject to U. S. income taxation.

Post differentials are subject to taxation.

TO THE RECORD

1. This Office has sought to clarify the liability of employees for U. S. income tax on living-quarters allowances. The Internal Revenue Code (IRC), Sec. 912, provides that the following items shall not be included in gross income and shall be exempt from taxation:

"(1) COST-OF-LIVING ALLOWANCES - In the case of civilian officers or employees of the Government of the United States stationed outside continental United States, amounts received as cost-of-living allowances in accordance with regulations approved by the President.

"(2) FOREIGN SERVICE ALLOWANCES - In the case of an officer or employee of the Foreign Service of the United States, amounts received by such officer or employee as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (22 U.S.C. 1131-1158)."

2. Generally, there are two groups of allowances, defined as "living-quarters" and "cost-of-living." "Living-quarters" allowances are temporary lodging allowances and quarters allowances. "Cost-of-living" allowances comprise post, transfer and separation allowances. (A tentative approach by the State Department also includes the education allowance, but this is not yet established.) It should be understood that allowances are separate and distinct from post differential. Allowances are designed to relieve certain economic hardships of living overseas. Post - or more properly salary - differential is a recruitment incentive where the environment differs substantially from that of the U. S. and is granted only where one of the following exists: "(a) extraordinarily difficult living conditions, (b) excessive physical hardship, or (c) notably unhealthful conditions." There is no question of the tax liability for post differential since, in the absence of a congressional mandate, it is an increment of salary and therefore taxable income. The allowances are another matter. For foreign areas outside the territories and possessions of the U. S., they are clearly distinguished from the salary differential

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in regulations (Standardized Regulations, Government Civilians, Foreign Areas) issued by the Secretary of State. For territories, i.e., Alaska and any other area outside the continental U. S., the Civil Service Commission pays an amount not in excess of 25 per cent of the basic salary. The nature of the payment is identified as either post differential or cost-of-living allowances. However, there are no territorial living-quarters allowances as such.

3. In view of the language of Sec. 912, IRC, it was not clear that civilian employees of the Government who were not members of the Foreign Service were entitled to an exemption for living-quarters allowances "outside the continental U. S." We are now informed that the Internal Revenue Service, in an unpublished opinion, has ruled that the term "cost-of-living" is construed in this instance to include "living-quarters" allowances. Thus, neither the value of the quarters nor the allowance in lieu thereof needs be reported as taxable income. This applies however only to individuals who are actually employees. In this regard, the actual status under the common-law definition will control. Executive Order 10,000, Sec. 209, provides that persons serving under contract are not entitled to the territorial cost-of-living allowances and it would, therefore, appear that any individual in this situation would be required to treat anything designated as an allowance as taxable compensation without regard to the intrinsic nature of his status.

4. Thus, employees are not required to pay a U. S. income tax on cost-of-living allowances. For purposes of the exclusion, "cost-of-living" includes quarters or an allowance in lieu thereof. Whether an individual is an "employee" will be determined by the Agency, and where it is decided that the individual is actually an independent contractor the exemption will not be available since he is neither an officer nor an employee.

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